thereby resulting in a system of cross-subsidization that would not only be inefficient, but ultimately in shambles.

The Telecom Act In Perspective

Before outlining some of the steps involved in facilitating competition in the local exchange segment of this industry, I think it is helpful to take a look back -- to the history of the development of competition that eventually permitted deregulation of the long distance market.

In 1974, the Justice Department concluded that microwave technology allowed long distance firms like MCI to compete against AT&T in long distance, but that AT&T had been using its control over the local exchanges to stall competition in that sector. After the Department obtained divestiture relief nine years later through a consent decree, it still required an additional twelve years before sufficient competition took hold so that AT&T's long distance prices were de-regulated.[2] During those twelve years, the Justice Department, the FCC, and the state PUCs all put in considerable effort restructuring the regulatory framework in order to facilitate competition where regulated monopoly had previously reigned. Two particularly challenging undertakings in this regard were the implementation of the equal access portions of the consent decree -- which promised all long distance carriers parity in access to the local

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[2]Specifically, the Commission concluded in 1995 that "most major segments of the interexchange market are subject to substantial competition today, and the vast majority of interexchange services and transactions are subject to substantial competition." Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Order, 11 FCC Rcd 3271, 3288, ¶26 (1995). As of 1996, AT&T had a market share of 48%, MCI 20%, Sprint 10%, Worldcom 6%, and all other long distance carriers 17% (individually all about 1% or less) based on revenues. Federal Communications Commission, Long Distance Market Shares, Table 6 (Oct. 10, 1997).

telephone network -- and the development of a complex system of charges to bill for such access.

As a result of the efforts to open up the long distance market, competitors have increasingly entered that market and prices have fallen dramatically -- on average, consumers now pay 60% less, adjusted for inflation, than they did when AT&T was broken up in 1984.[3] Consumers today have a choice of literally scores of long distance providers, each with different options and offerings. And AT&T has been forced to compete for its customers, losing forty percent of its market share since 1980, and now offering many consumers a-dime-a-minute long distance phone calls.

Bringing competition to the local market will also take time -- not twenty-one, or even twelve, years, I should hope -- but time. Indeed, in some respects, our present undertaking is likely to be even more challenging than the one we faced in bringing competition to long distance. By divesting the local operating companies from AT&T's long distance operations, the AT&T consent decree removed the ability of the integrated Bell System to use its control of essential inputs to discriminate in favor of itself vis-a-vis its competitors. And the development of alternative long distance networks by new competitors proved to be reasonably affordable. By contrast, the creation of new networks and the risk of discrimination in their absence are at the heart of the challenge we face in bringing competition to local telephony. The simple fact is

[3]B. Douglas Bernheim and Robert D. Willig, The Scope of Competition in Telecommunications 68 (1996).

that no one can be certain that, like in long distance, we will see the development of fully redundant local networks that could simply by-pass the current incumbent monopolists. Consequently, the 1996 Act properly charts a very different course from that adopted in the AT&T consent decree: it uses regulatory, contractual, and antitrust oversight to ensure that the local companies share their essential inputs with their would-be competitors. The theory behind this approach is that once the incumbents and the new entrants have instituted the arrangements necessary for sharing essential facilities, we can then expect that such arrangements will become more and more regularized (and legally enforceable).

At least two things make the type of sharing arrangements envisioned by the Telecom Act difficult to implement. First, shared inputs must be priced; and those prices can determine the relative success of the new entrants vis-a-vis the existing incumbent monopolist. Not surprisingly, people are going to fight over those numbers. And each side understandably wants a margin of error to protect itself. Furthermore, as is always the case with price regulation, there is, by definition, no market-based solution, so government agencies must serve as an imperfect substitute for the market and, like it or not, this inevitably adds a dimension of politics -- real or perceived -- to the process. This fight about pricing is what most of the ongoing litigation is all about.

Second, even in circumstances where prices are not an obstacle, developing the relevant rules of the road, as well as the systems necessary for implementing these rules, often proves difficult in practice. Just as it took time to work out the hand-off from cellular to the local loop, so too will the hand-off from the local incumbent to the new entrant take time -- especially when the incumbent that is being asked to complete the hand-off is being told to "make nice" to someone who has just taken away one of its customers.

To deal with these matters, the Telecom Act adopted a two-part strategy: the sticks of enforceable obligations and the carrot of in-region long distance entry. As the Act conceives it, the Bells must offer new entrants an equal opportunity to compete for local telephone service customers. And, once they have achieved this goal, the Act allows for Bell entry into the long distance markets in their respective regions. In essence, then, the Act envisions that the local and long distance companies will enter each other's markets and offer new and improved services, including bundled offerings of local and long distance, at better prices to consumers.

Obviously, the ability to implement the Act will depend, at least in part, on the efficacy of the sticks and carrots, so let me say a few words about each. As for the "sticks," there are real questions at this point: the Act itself calls for no real penalties for non-compliance and, at least on the Eighth Circuit's view, the FCC may only have limited -- if any -- authority to fine companies for failure to comply. The state PUCs may be able to help here, and some states legislatures, like Illinois, have already adopted regulatory schemes to police compliance, but, as of yet, such schemes have not been instituted in most states. Of course, the Telecom Act makes clear that Section 2 of the Sherman Act still applies to this industry and, generally speaking, this statute provides effective remedies designed to deter abuses of market power, with treble damages where appropriate. Nevertheless, as Congress wisely recognized, antitrust remedies are not well suited to serve as the first line method for opening the local market. This fact of life, in combination with the uncertainty about how the statutory obligations are to be enforced, means that the carrot of long distance entry appears to be the primary means of ensuring Bell Company compliance with the Act's market-opening provisions.

And, in that regard, it is apparent that different Bells have different appetites for this carrot, depending on each one's particular assessment of its own best interests. Our experience has been that, while the Bells are obviously interested in in-region long distance entry, most are still trying to decide whether it is worth the price -- and by price, I mean what we and the FCC are requiring in the way of statutory compliance. And, to further complicate the analysis, several Bells appear to be weighing the likelihood that, despite the delay and uncertainty attendant to judicial proceedings, they will get a better deal from the courts than from the FCC and us. My own sense on this is that, while we will continue to observe a range of responses, in the end, the Bells will conclude that the loss of desirable customers to new entrants, coupled with the appeal of becoming a one-stop shopping company will ultimately lead to Section 271 compliance.

Opening Up The Local Market

Now, if I can move away from the big picture, I would like to turn to some of the sticky details that need to be worked out in this wonderful period known as the "meantime." In particular, I want to say a few words about how uncertainty -- both in terms of what entrants can expect and in terms of what the law requires of the incumbents -- delays competition. And in this regard, I want to focus on three issues: (1) the development of the prices for the wholesale inputs; (2) the legal disputes that have arisen in implementing the Act's requirements concerning the combining of individual elements unbundled from an incumbent's network; and (3) the technical development of the systems necessary to support competition in the local market.

On the pricing issue, there has been a lot of rhetorical crossfire in the battles that have been waging in the regulatory and legal arenas over the rates for leasing access and interconnection to the incumbent's network as well as for purchasing resold services. At the end of this process -- with whatever role is to be played by the state PUCs, the federal courts, and the FCC -- it will be necessary to put in place prices that will enable efficient competition to move forward. In our recent filing on BellSouth's Section 271 application for South Carolina, we explained that, at a minimum, the Department's statutory charge under Section 271 to conduct a competitive assessment of the merits of any Section 271 application allows us to evaluate whether the prices in a given state were the product of a pro-competitive methodology that was applied in a reasoned manner and will remain in place over time so that new entrants can make investment decisions with some confidence about the future pricing of essential inputs. Let me emphasize that, under our competitive analysis, we have insisted on a consistent set of procompetitive pricing principles, not on any single pricing formula; thus, we would not accept, for example, that backward looking costs -- like embedded, uneconomic (or "stranded") costs or universal service subsidies -- have a place in a wholesale pricing structure designed to foster efficient entry.

A second important aspect of implementing the Act is translating some of the broad statutory terms into specific legal rules. Although this process is moving forward in different contexts, one important issue addressed in our South Carolina evaluation relates to the legal machinations that have been going on about how an incumbent is supposed to allow an entrant to combine the individual unbundled elements of the incumbent's telephone network. Section 251(c)(3) of the Act states that the individual elements unbundled from an incumbent's network must be provided in a way that allows the requesting carrier to combine them in order to provide service. The FCC's Local Competition Order explained that this provision meant that new entrants were entitled to lease all of the individual elements to provide service, even if the new entrant was not using any of its own facilities. The Eighth Circuit upheld this regulation, but vacated a second Commission regulation requiring that incumbents provide new entrants with access to the already connected elements of their own network.

Given the recent rulings on the "rebundling" issue, we are today in the uncomfortable, and inefficient, situation in which the incumbents are allowed to do some work -- uncombine elements already in place -- so that the new entrants can do more work -- by re-combining them. In our evaluation of BellSouth's recent Section 271 application, we explained that, because it had failed to outline the specific process and procedures by which new entrants could do this re-combining, it had failed to implement the mandate of Section 251(c)(3). In the meantime, with litigation changing the regulatory landscape, we have yet to determine what sorts of arrangements would provide reasonable access in this regard. We have resisted any rush to judgment on this issue because we want to hear from the companies themselves about what solutions make sense given where we are now in terms of the implementing of Section 253(c)(3).

The third aspect of opening the local market that I want to mention is the challenge of instituting new technical arrangements that will enable competition to take root in local telephone markets. For simplicity purposes, let me use the term "wholesale support systems" to encompass the range of functionalities and operational systems that an incumbent must make available to a new entrant so that the entrant can switch over and serve customers previously served by the incumbent. In this regard, you may already have heard people talking about "operations support systems," or OSS for short, which are, as the FCC explained in its Local Competition Order, important checklist items as well as a means for making resold services and access to unbundled elements available in a meaningful manner.

As we have explained in our three Section 271 evaluations filed thus far, effective wholesale systems are essential to making meaningful competition possible. Obviously, a new entrant is at the mercy of the incumbent provider when it asks the incumbent to switch over a customer or to suppress the incumbent's billing systems so that a customer is not receiving two bills -- one from the new entrant and another from the incumbent. With respect to resale, the incumbent's wholesale systems are even more critical because, unless the incumbent is processing orders in a timely fashion, the customer may be forced to wait for several weeks or even months before being switched over to the competitor, depending on the backlog of orders sitting at the incumbent's headquarters. The rub here is that if service cannot get turned up in a timely fashion, or if there are other operational problems, the customer will hold the *new entrant* -- not the delinquent incumbent -- responsible for the failure. Consequently, new entrants may tend to delay ramping up their operations until they gain a level of confidence in the incumbent's systems.

In addition to getting the right systems in place, we also need to ensure that these systems remain in place after Section 271 authority has been granted. As you may know from our evaluations, we intend to accomplish this by insisting on appropriate performance measurements as a condition of entry. Thus, once the Bell is reporting satisfactory levels of performance and has committed to performance standards, we can support Bell entry with the knowledge that a "benchmark" of satisfactory performance has been set, thereby enabling post-entry remedies -- contractual, regulatory, and antitrust -- to guard against any "backsliding" on the Bell's earlier wholesale performance. With the right measures in place, and our recent filing in South Carolina explains which ones we consider important, we believe that post-entry measures, such as halting future long distance marketing authority, can serve as an effective incentive for encouraging the Bell to maintain its levels of performance.

The three areas I just discussed are certainly not the only areas critical to competition, but they are three areas in flux that will need to be resolved effectively if large scale competition is to move forward. I have tried to spare you all the details, but I hope that this discussion, abridged though it may be, indicates why this market opening process is not for sprinters. Now, if all of this were not complicated enough, let me turn to the often difficult problems that make competition for local residential customers -- especially outside of the major cities -- an especially elusive goal.

Competition for Residential Customers

There are several additional considerations that may help explain the especially slow pace of residential competition other than the obstacles to competitive entry generally -- namely, the relative costs of serving different classes of customers (e.g., urban/rural, business/residential), our present system for supporting universal service, and delays in rolling out new technologies.

As an initial matter, serving business customers will often be more attractive to competitors than serving residential customers because business customers generally use multiple lines and make more, and more expensive, calls. In addition, under our present system for ensuring affordable telephone service, certain services are priced at above-cost rates to subsidize other services, often leading to a situation where large business customers are far more attractive to competitors. Some states, for example, allow the incumbent to charge above-cost rates for multiple business lines in order to subsidize -- albeit, implicitly -- the incumbent's rates for basic dialtone. To be sure, the Act calls for these implicit subsidies to be made explicit and available to entrants seeking to serve high-cost areas, but until that transition occurs, entrants will be left with the prospect of competing to serve certain residential customers at below cost-rates -- at least if they intend to serve those customers via unbundled elements. Of course, if new technological advances -- such as a wireless local loop or cable telephony -- enable new entrants to underprice the incumbent's subsidized residential service, that would facilitate residential local entry, but those advances do not appear to be imminent.

Of the factors that I just mentioned as bearing particularly on the pace of residential competition, only one is completely in the control of government -- our system for ensuring universal service. As competition in urban areas and for business customers takes root, there will be more and more fiber laid in the ground and other arrangements for competitive offerings that will also benefit residential customers. And, as technology advances, the cost of delivering service may decrease considerably, thereby bringing residential customers new products at better prices. But, even as such developments take place, residential customers still will not get the full benefit of competition if we continue to rely on a system of implicit -- as opposed to explicit -- subsidies that make at least some of them unattractive to competitive carriers. To illustrate this point, let me refer to a specific example.

In South Carolina, ACSI, a competitive local exchange company, reports that it must pay $19.45 per month for an unbundled loop and the associated charges -- not to mention its other capital and operations costs -- to serve a residential customer who presently pays $19.95 per month for basic dialtone. Now, perhaps ACSI could profitably serve such residential customers if they use vertical or enhanced features (e.g., call waiting or voice mail) or who spend money on long distance calls. But it certainly will not choose to market to customers if they essentially use only basic dialtone.

On the other hand, under an explicit system for subsidizing universal service, a customer would pay the affordable rate, say $19.95 per month in South Carolina, and a subsidy would be given to the carrier -- the incumbent or a new entrant -- that serves that customer. If this subsidy were explicit and available to all carriers, companies would find it profitable to go after all customers and would be able to compete with the incumbent for their business on the merits. The FCC and the states are now in the thick of the process of making these implicit subsidies explicit, and as you all appreciate, calculating what this subsidy will be in different areas is a difficult task and a highly charged undertaking. But once an explicit, competitively neutral system for ensuring affordable universal service is put in place, it will provide an important incentive for competitors to go after the mass market. Until this is accomplished, however, we must be candid in acknowledging that our present system of implicit universal service subsidies is a real impediment to full scale residential competition.

Signs of What is Yet to Come

As is my nature, I would like to end on an optimistic note, so let me say that while there are problems in getting local competition going, we should still be mindful of the tangible progress that has occurred thus far and the hopeful signs for what lies ahead. According to Ameritech, there are over 400,000 customers now be served by competitive local carriers in its region, with over 3,000 customers switching to one of Ameritech's competitors each day. And other regions are starting to see similar results. Just recently, moreover, Teleport, a relatively small new local entrant, was awarded a contract to serve the telecommunications needs of all city government offices in San Diego, allowing the city to reduce its expenses by approximately

20 percent.[4] As encouraging is the flow of capital being raised by companies gearing up to offering local telephony: in the first half of this year alone, competitive local exchange carriers raised over 6 billion dollars.[5]

As we get further along into this process, we will continue to see a greater convergence among utilities, cable, and telephone companies, bringing new and better services to consumers. In states such as Massachusetts, Texas, California, New York, and right here in the District of Columbia, cable and utility companies are employing excess capacity on their own, often underutilized, lines to provide competitive local phone service. In Massachusetts, Boston Edison, an investor-owned electric utility company, through a partnership with RCN Telecom Services, is providing local, long distance, data, and video services as part of a bundled service offering to approximately 4,000 subscribers.[6] This summer, CSW/ISG ChoiceCom -- a partnership between an electric utility and a competitive local exchange company -- said it had connected its first local service customers in Austin and Corpus Christi, Texas.[7] And, at the same time, Cox Communications, a cable television company, launched a large scale residential offering of digital telephone service in Orange County, California to 1,500 households. By the

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[4]TCG began investing in San Diego's telecommunications infrastructure in 1993, three years before the passage of the Telecom Act.

[5]*Communications Business & Finance* (May 12, 1997) (statement of Bruce Eatroff, Vice President at UBS Securities).

[6]See Richard Hahn's testimony before the House of Representatives Commerce Committee Subcommittee on Telecommunications, Trade, and Consumer Protection. (July 29, 1997).

[7]*Communications Today*, (August 7, 1997).

end of next year. Cox plans to be able to offer its phone services to 265,000 households in its Orange County service area.[8] In New York, Cablevision is now rolling out -- on a limited basis, to start -- its HFC technology to provide cable, telephone, and Internet access to customers on Long Island. And just last month, Pepco announced plans to offer a high-speed fiber optic network that will provide cable, phone, and Internet to its customers in Washington, DC.

For those who want to look a little further into the future, the progress of competition in wireless services provides reason for optimism -- and potentially, even a full-scale competitor to local wireline service. In Texas for example, PrimeCo, a wireless provider, charges a flat rate of 10 cents a minute for intrastate calls, calls for which the local Bell is allowed to charge up to 36 cents a minute.[9] And, according to the Wall Street Journal, AT&T is developing digital wireless technology that could cost consumers as little as $10 per month for unlimited local calling.[10] With the entry of additional wireless providers into many local markets, there are now five different wireless providers in many cities, including D.C. You don't have to be an economist to know that good things start to happen when you have that many companies competing in a market.

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[8] See Cox Communications Press Release from September 10, 1997, "Cox Communications Launches Cox Digital Telephone."

[9] "Unfettered, Phone Users Go All-Wireless," *The Wall Street Journal Europe*, (August 22, 1997).

[10] Wall Street Journal (February 24, 1997).

Conclusion

In the midst of the overheated rhetoric by the industry participants, as well as the unmet expectations about what was promised during the debates over the Act, there are those who would appear to be more interested in pointing fingers than in solving the problems necessary to make the Act work. In my view, the fact remains that with new technology on the horizon and the attractiveness of serving all of a customer's telecommunications needs -- be it cable, wireless, local, long distance, paging, Internet access, what have you -- our old communications laws premised on regulated monopolies threatened to impede real progress in this industry. The 1996 Act represented only the first -- though, a very bold -- step, leaving much hard work to be done. But it is work that should be done and, for our part, we at the Justice Department have our sleeves rolled up and plan to rise to the occasion. In so doing, we will continue working with the states, who have played a vital role in the process, as well as the FCC, which now has new leadership to continue the march through this difficult terrain. At this point in time, when we are in the midst of the process of taking on the difficult tasks along the way, I know that it is not always easy to keep an eye on the big picture, but I am confident that our journey to competition, though not easy, will be well worth the work.